IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

TAX APPEAL No.157 of 2000
AND
TAX APPEAL No.328 of 2000

For Approval and Signature:

HON'BLE MR.JUSTICE D.A.MEHTA Sd/-
and
HON'BLE MS.JUSTICE H.N.DEVANI Sd/-

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : NO

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the concerned Magistrate/Magistrates,Judge/Judges,Tribunal/Tribunals? : NO

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Appearance:

1. TAX APPEAL No. 157 of 2000
MR SN SOPARKAR for Appellant No. 1
MR MANISH R BHATT for Respondent No. 1

2. TAX APPEAL No. 328 of 2000
MR MANISH R BHATT for Appellant No. 1
MR SN SOPARKAR for Respondent No. 1

CORAM : HON'BLE MR.JUSTICE D.A.MEHTA
and
HON'BLE MS.JUSTICE H.N.DEVANI

Date of decision: 21/04/2005

COMMON ORAL JUDGEMENT

(Per : HON'BLE MR.JUSTICE D.A.MEHTA)

1. As both these appeals involve common facts, they have been heard together and are disposed of by this common judgement and order. The dispute between the parties centres round taxability of interest income in hands of the individual assessee and corresponding deduction of liability in hands of the company. The Assessment Year is 1995-1996 and the relevant accounting period is Financial Year 1994-1995 i.e. year ended on 31st March, 1995. The assessment year and the accounting period are same for the individual assessee as well as the company.

TAX APPEAL NO.157 OF 2000

2. The following substantial question of law has been formulated at the time of admission of the appeal on 27th September, 2000:

"Whether, in the facts and circumstances of the case, the ITAT was right in law in holding that the assessee was not entitled to the deduction of interest paid by it on the debentures issued by it ?"

3. In this Tax Appeal the payer company is the appellant. The payer company while filing its return of income claimed deduction of the total amount of interest paid on the ground that the interest paid was a revenue expenditure and could not be disallowed as the same was paid by way of rent for use of capital. It was further contended that deduction of interest under Section 36(1)(iii) of the Income-tax Act, 1961 (the Act) only required that interest is paid in respect of capital borrowed for the purposes of business of the borrower. That the payer company had in fact satisfied the requirements of the said provision and once payment had been made there was no question of disallowing the interest. Reliance was also placed on the provisions of Section 43(2) of the Act which define the term 'paid'. The Assessing Officer did not accept the contentions of the payer company and held that interest payment Rs.62/- per debenture payable up front on the date of allotment was nothing but advance payment for the entire period of six years and that interest @ Rs.62/- per debenture having face value of Rs.100/- could not be

interest for a period of seven days of the accounting period. He, therefore, held that the payer company cannot state that the entire interest was paid on the date of allotment and for the remaining period of the loan, namely, for a period of six years the borrowing was interest free. Accordingly, the claim of deduction of interest paid on debenture was proportionately allowed to the extent of Rs.84,224/- and balance of Rs.2,62,65,776/was disallowed.

4. The assessee i.e. the payer company carried the matter in appeal but did not succeed. According to CIT (Appeals) the ratio laid down by the Apex Court in the case of Madras Industrial Investment Corporation Limited (supra) squarely applied to the case of the payer company and the Assessing Officer was justified in allowing deduction of only proportionate amount of interest.

5. The payer companies, four in all, carried the matter before Tribunal but the Tribunal, after setting out the facts and contentions of the parties, held that the facts of the case were similar to the facts of the case before the Apex Court in case of Madras Industrial Investment Corporation Limited (supra) and, accordingly, the orders made by the Assessing Officer and CIT (Appeals) were upheld.

6. Mr.S.N.Soparkar, learned Senior Advocate appearing on behalf of the appellant, submitted that the payer company had claimed deduction under provision of Section 36(1)(iii) of the Act. The Apex Court decision in case of Madras Industrial Investment Corporation Limited (supra) was based on the footing that the controversy was under the provision of Section 37 of the Act and, therefore, according to Mr.Soparkar, the said decision had no application on facts of the case. Referring to definition of the term 'paid' he submitted that paid means actually paid or incurred according to method of accounting upon the basis of which profits and gains are computed under the head 'Profits and gains of business or profession'. Therefore, according to Mr.Soparkar once the payer company had actually paid there was not only incurring of expense as per definition of the said term but also actual out going from the coffers of the payer company. That the payer company had deducted tax at source on the entire payment made in the relevant accounting period and the said tax had been deposited with the Central Government. He, therefore, submitted that the Tribunal had incorrectly applied the ratio of the Hon'ble Supreme Court decision without appreciating the facts of the case, with special

reference to the terms of debenture. Inviting attention to Condition No.2 which deals with interest rate and manner of payment it was contended that the payer company was bound by the terms of the covenants and accordingly in discharge of such obligation it had made payment of interest to the debentureholder and was entitled to the deduction of the said amount.

7. As against that Mr.M.R.Bhatt learned Senior Standing Counsel appearing on behalf of the respondent Revenue, submitted that the impugned order of the Tribunal did not call for any interference as the same was based on the Apex Court decision. According to Mr.Bhatt, issuance of debenture by the payer company was nothing but raising of funds by way of loan on which interest was payable to the debentureholder, but as per commercial accounting principles, interest was for user of the said fund and would accrue or arise on a day-to-day basis as and when the funds were employed for the purposes of business. He, therefore, supported the order made by the Tribunal with a plea that the same may be upheld.

8. As the facts narrated hereinbefore go to show the case of the respondent - assessee in Tax Appeal No.328 of 2000 and the appellant - assessee in Tax Appeal No.157 of 2000 is primarily based on the debenture issued by the company; namely, tax treatment of interest which is payable by the company and receivable by the individual debentureholder under the debenture. The relevant portion of the debenture certificate shows that debentures are issued in terms of the Debenture Trust Deed dated 31st March, 1995 in pursuance of Resolutions passed by the Board of Directors of the Company on 24th March, 1995 as well as by the general body at the Extra Ordinary General Meeting held on 24th March, 1995. Accordingly, the company has issued Secured Redeemable Non-Convertible Debentures each of Rs.100/-; and as the specimen certificate available on record shows Amount Paid Up Per Debenture is Rs.100/-. It is further stated in the certificate that "The Debentures are issued subject to and with the benefit of the Financial Covenants and conditions endorsed hereon which shall be binding on the Company and the Debentureholders and all persons claiming by, through or under any of them and shall ensure for the benefit of the Trustees and all persons claiming by, through or under them. The Company hereby agrees and undertakes to duly and punctually pay, observe and perform the Financial Covenants and Conditions endorsed hereon.".

9. As per Financial Covenants and Conditions, Condition No.2 relatable to "Interest Rate and Manner of Payment" and Condition No.3 relatable to "Redemption" read as under :

"2. INTEREST RATE AND MANNER OF PAYMENT

Each Debenture shall carry interest @ Rs.62.00 payable up front on the date of allotment.

3. REDEMPTION

The Company agrees and undertakes to redeem the Debentures at par in one instalment at the end of 6th year from the date of allotment."

10. On plain reading it becomes apparent that each debenture was to carry interest @ Rs.62/- payable up front on the date of allotment. Therefore, on each debenture having face value of Rs.100/-, interest of Rs.62/- was payable on the date of allotment, which is admittedly 24th March, 1995. There is no dispute that the Company has in fact made payment of interest to the debentureholder on the date of allotment, deducted tax at source on such payment in accordance with the provisions of the Act, and paid over such tax to the credit of Central Government. Therefore, the payer company has fulfilled its part of obligation arising from the contract between the parties. As already reproduced hereinbefore the Company had agreed and undertaken to duly and punctually pay, observe and perform the Financial Covenants and Conditions endorsed on the debenture certificate. It has done so. The limited question that would then survive is whether the Company is entitled to deduction of such amount while computing its taxable income.

11. Section 36(1) of the Act lays down that the deduction provided in the clauses that follow shall be allowed in respect of the matters dealt with in the respective clauses while computing the income referred to in Section 28 i.e. income from profits and gains of business or profession. Clause (iii) of sub-section (1) of Section 36 reads "The amount of interest paid in respect of capital borrowed for the purposes of the business or profession". The Proviso and the Explanation thereunder are not reproduced as they are not relevant for the present. Therefore, on a plain reading for an

assessee to become entitled to deduction under Section 36(1)(iii) of the Act while computing income under the head 'Profits and gains of business and profession' the assessee has to establish that it has paid interest in respect of capital borrowed for the purposes of business. In the present case, it is an admitted position between the parties that, the payer company is carrying on business, it had borrowed capital by way of debenture issued for such business, and it had paid interest in respect of such capital borrowing. The payer company, therefore, has satisfied all the conditions necessary for invoking Section 36(1)(iii) of the Act and is thus, entitled to deduction of interest paid while computing its income from profits and gains of business.

12. As rightly contended on behalf of the payer company, Section 43(2) of the Act which defines the term 'paid' would take within its sweep as per the definition both "actual payment" as well as "incurring of a liability" according to method of accounting on the basis of which profits and gains of business are computed. The said definition is applicable wherever the term 'paid' is used in Sections 28 to 41 of the Act, unless the context otherwise requires. In the circumstances, the term 'paid' as used in Section 36(1)(iii) of the Act would have the same meaning and as per method of accounting regularly employed, on the basis of terms of contract, the payer company had incurred the liability and discharged the same during the accounting period. In other words, not only was there an incurring of liability but there was actual payment of interest. In these circumstances, it is not possible to accept the stand of Revenue that despite the total amount of interest having been paid during the relevant accounting period as per the terms of the contract between the parties, only proportionate amount should be deducted while disallowing the balance which would be allowable in subsequent years.

13. The Apex Court decision in case of Madras Industrial Investment Corporation Limited (supra) cannot be pressed into service by Revenue because, admittedly, the Court was called upon to decide the controversy in light of the provisions of Section 37(1) of the Act. Section 37(1) of the Act specifically states that any expenditure (not being expenditure of the nature described in Sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee) shall be allowed in computing the income chargeable under the head 'Profits and gains of business or profession' if it is laid out or expended wholly and exclusively for the purposes of business. Therefore,

once it is shown that an expenditure is of the nature described in any of the specified Sections i.e. Sections 30 to 36, the same cannot fall within Section 37(1) of the Act. In the circumstances, the assessee's claim being under Section 36(1)(iii) of the Act, there is no question of applying principles on the basis of which deduction of an expenditure is permissible under provisions of Section 37(1) of the Act.

14. There is one more aspect of the matter. The Company issuing the debenture, under which the borrowing is made, has entered into a contract with the debentureholder. It is nobody's case that the contract is sham or not acted upon. In the circumstances, the parties are bound by the terms of the contract and it is not open to any third party, including Revenue or the Court, to rewrite the terms of the contract. During course of hearing, on behalf of Revenue, attention was invited to observation made by the Assessing Officer regarding applicability of ratio of McDowell and Co. Ltd. Vs. Commercial Tax Officer, [1985] 154 ITR 148 (S.C.) to contend that there was a transaction entered into between the parties so as to take double advantage. Whether the transaction is entered into with the object of tax planning or not is an entirely different matter than the contract being sham or not being acted upon by parties. At the cost of repetition it requires to be stated that both the assessees, namely, the payer company as well as the recipient on one side and Revenue on the other side have relied upon the terms of the contract so as to suit their convenience while bringing to tax the interest income or while denying the deduction in hands of the payer; in bringing to tax the entire amount or while seeking spread over of such interest, but none of the parties to the dispute have stated that the contract has not been acted upon. In the circumstances, in absence of any contrary provisions under the Act, the parties are required to be governed by the terms of the contract and the transaction in question is required to be appreciated in context of the same. Hence, it is apparent that the payer company has made payment of entire amount of interest on the date of allotment and sought deduction thereof in the year of payment. There is no question of the same being denied in light of the fact that as per terms of the contract no other mode of interest payment is stipulated by the covenants which form part and parcel of the debenture certificate.

15. The contention raised on behalf of Revenue that interest would accrue only on a day-to-day basis does not merit acceptance in light of the fact that the parties

have specifically provided for a particular rate of interest as well as the manner of payment. Once that is so, it is not possible to rewrite the same and state that interest would accrue, or liability to pay interest would accrue over the entire period of debenture i.e. six years. If this is not possible, the entire interest payment made in the initial year of allotment cannot be artificially spread over the period of six years for the purposes of allowing deduction.

16. In these circumstances, the question raised in Tax Appeal No.157 of 2000 is answered in the negative. The Tribunal was not right in holding that the assessee i.e. the payer company was not entitled to deduction of interest paid by it on the debentures issued by it in the assessment year under consideration.

17. At this stage, it is stated by learned Advocate for the appellant company that pursuant to the impugned order of Tribunal if any claim is made by each of the payer companies in any of the subsequent years on the basis of proportionate payment in accordance with the order of the Tribunal, the respective assessee companies shall have no objection if the claims which might have been allowed are withdrawn and additions made to the said extent considering that the entire claim of deduction of interest paid is allowed in Assessment Year 1995-96.

TAX APPEAL NO.328 OF 2000

18. The following substantial question of law has been formulated at the time of admission of the appeal on 8th November, 2000:

> "Whether, the Appellate Tribunal is right in law and on facts in holding that the interest income in the hands of the assessee who was allotted debentures by the Companies is required to be taxed only on proportionate basis and that the Commissioner of Income Tax (Appeal) was not justified in sustaining the addition of the whole amount of interest at the rate of Rs.62/- per debenture in the accounting year in question ?"

19. The appellant of this Tax Appeal is an individual. The individual assessee made investment to the tune of Rs.2,15,00,000/- by way of subscribing to debenture issue of one Rupam Mercantile Limited; the assessee also made similar investment in debenture issue of Mohit Marketing Limited to the tune of Rs.4,25,00,000/-.

20. Individual assessee filed return of income on 30th January, 1996 declaring total income of Rs.7,63,86,741/- which included debenture interest to the tune of Rs.1,94,178/-. The Assessing Officer assessed the said debenture interest as returned by the assessee but also made protective assessment by making addition of a sum of Rs.4,16,55,822/-. According to the Assessing Officer, the payer company had made payment of debenture interest of a total sum of Rs.4,18,50,000/- as per the certificate of tax deduction which was filed along with the return of income, and hence, the assessee had incorrectly shown only interest relatable for the accounting period. It was the case of the assessee before the Assessing Officer that the debentures had been issued on 24th March, 1995 and hence only proportionate interest relatable for a period of seven days of the accounting period had been returned by the assessee while the balance would be shown as interest income in subsequent assessment years. According to the assessee, holding of debenture was nothing but advancing of loan to the company and interest would accrue on a day-to-day basis on the user of the funds so advanced by the assessee to the company. That the term of debenture was a period of six years and hence, the assessee was not entitled to interest, there being no accrual of such interest except for the period relatable to the assessment year. The Assessing Officer negatived the said claim by holding that the assessee had claimed credit of tax deducted at source for the full amount of interest on the basis of the certificate issued by the company.

21. The assessee carried the matter in appeal before CIT (Appeals) who upheld the addition made by the Assessing Officer but on a substantive basis. The CIT (Appeals) held that the entire interest income had become due to the assessee, had accrued to the assessee and had also been received during the accounting period relevant to Assessment Year 1995-1996. He also turned down the plea of the assessee that on the system of accounting regularly employed by the assessee, namely, mercantile system of accounting, only proportionate interest was taxable in hands of the debentureholder. It was further held that accounting treatment of an item of expenditure in hands of the payer company can be different from the accounting treatment of the same item by way of corresponding receipt in hands of the payee. The contention raised by the assessee that the debentures were in the nature of Deep Discount Bonds was also rejected.

22. Being aggrieved, the assessee filed second appeal before Tribunal. The Tribunal passed a consolidated order on 20th October, 1999 in case of three individuals including the present assessee as the issue was common in all the three cases. The Tribunal took into consideration the terms and conditions of the debentures which were described as Financial Covenants and Conditions. As per the condition relatable to payment of interest, namely, Condition No.2 whereby interest was payable at the rate of Rs.62/- per debenture up front on the date of allotment, it was observed by the Tribunal that merely because by contract interest is received in a lump-sum manner much before the interest accrues cannot lead to a conclusion that the whole receipt is taxable in case of an assessee who maintains his accounts on mercantile basis. That interest was in the nature of compensation payable to the creditor for depriving the creditor of his capital and it, therefore, arose on a day-to-day basis only. The Tribunal also examined the transaction and came to the conclusion that the nature of the debentures was akin to Deep Discount Bonds and referring to instructions issued by the Central Board of Direct Taxes on 12th March, 1996 came to the conclusion that the entire amount was not taxable and only the proportionate amount as shown by the assessee was taxable in his hands. The Tribunal placed reliance on decision of the Hon'ble Supreme Court in case of Madras Industrial Investment Corporation Limited Vs. Commissioner of Income-tax, [1997] 225 ITR 802 and held that applying the ratio of the said decision what was true for expenditure was equally true for income, because according to Tribunal, the principles enunciated by the Supreme Court were based on principles of commercial accounting.

23. Mr.M.R.Bhatt, learned Senior Standing Counsel appearing on behalf of the appellant - Revenue in Tax Appeal No.328 of 2000, assailed the impugned order of the Tribunal by inviting attention to the terms of the debenture to contend that each debenture carried interest @ Rs.62/- payable up front on the date of allotment and, therefore, entire income was taxable in hands of the individual assessee in the first year, namely, year of allotment and could not be spread over as claimed by the assessee over a period of six years which was the term of the debenture. He submitted that the assessee had actually received the interest income during the relevant accounting period and, therefore, there was no question of taxing the same proportionately on accrual basis. He, therefore, urged that the impugned order made by the Tribunal be quashed and set aside and the order made by

the CIT (Appeals), taxing the debentureholders on a substantive basis in relation to the entire interest income, be upheld.

24. As against that, Mr.S.N.Soparkar, learned Senior Advocate appearing on behalf of the respondent assessee, submitted that the individuals were following mercantile system of accounting. That as per such system of accounting entire interest income did not accrue during the accounting period but only a proportion had accrued despite the fact that there might be receipt which may be equivalent to the total amount of interest receivable. In other words, the contention was that receipt per se would not assume characteristic of income. That interest was nothing else but compensation for user of the monies advanced and in commercial world interest would accrue or arise or become due only on an de diem basis. That if substance of the transaction was taken into consideration it was apparent that interest was payable by way of rent for user of the funds advanced and agreement between the parties, though relevant, would not determine the characteristic of receipt. In other words, the receipt would assume colour of income only in accordance with the principles of commercial accounting and law. He, in this context, invited attention to the instructions issued by CBDT in case of Deep Discount Bonds, [2002] 254 ITR (Statute) 241 as well as Page 533 of Vol. (1) of Income Tax Law by Chaturvedi & Pithisaria 5th Edition.

25. In relation to the taxability of corresponding receipt in hands of the individual payee, it is necessary to note that entire amount of interest paid by company had been received during the relevant accounting period accompanied by certificate showing tax deducted at source. In these circumstances, it was not open to the recipient assessee to state that the entire interest was not taxable in his hands in the assessment year in question. As held in case of the payer company, as per terms of contract entire interest was payable up front on the date of allotment only and there is no other clause in the contract which would permit the payer company to defer payment of interest.

26. The contention raised on behalf of the individual assessee based on the following decisions

(i) Dr. Shamlal Narula Vs. Commissioner of Income-tax, Punjab, Jammu & Kashmir, Himachal Pradesh & Patiala, [1964] 53 ITR 151 (S.C.);

(ii) Rama Bai Vs. Commissioner of Income-tax, Andhra Pradesh, [1990] 181 ITR 400 (S.C.); and

(iii) Bikram Singh & Ors. Vs. Land Acquisition Collector & Ors., [1997] 224 ITR 551 (S.C.);

to the effect that interest is nothing else but compensation or rent for user of the funds requires to be rejected as the said proposition is not absolute. Firstly, all the three decisions deal with enhanced compensation in land acquisition matters where there is no borrowing; secondly, there is no contract between the parties; and lastly, interest is being paid under statutory provisions of Land Acquisition Act, 1894.

27. The next contention raised on behalf of the individual assessee is to the effect that despite there being receipt of the entire amount in the year of allotment there was no receipt of income during the year in question in light of the fact that the recipients were following mercantile system of accounting is not correct. The legal position and the effect of mercantile system of accounting as understood in accounting circles is stated as follows.

In the case of Commissioner of Income-tax, Madras Vs. A. Krishnaswami Mudaliar & Ors., [1964] 53 ITR 122 the Apex Court observed :

"Among Indian businessmen, as elsewhere, there are current two principal systems of book-keeping. There is firstly, the cash system in which a record is maintained of actual receipt and actual disbursements, entries being posted when money or money's worth is actually received, collected or disbursed. There is, secondly, the mercantile system, in which entries are posted in the books of account on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payment. For example, when goods are sold on credit, a receipt entry is posted as of the date of sale, although no cash is received immediately in payment of such goods; and a debit entry is similarly posted when a liability is incurred although payment on account of such liability is not made at the time. There may have to be appropriate variations when this system is adopted by an assessee who carries on a profession. Whereas under the cash system no

> account of what are called the outstandings of the business either at the commencement or at the close of the year is taken, according to the mercantile method actual cash receipts during the year and the actual cash outlays during the year are treated in the same way as under the cash system, but to the balance thus arising, there is added the amount of the outstandings not collected at the end of the year and from this is deducted the liabilities incurred or accrued but not discharged at the end of the year."
> (emphasis supplied)

Therefore, to contend that cash receipts would not partake characteristic of income only on the basis of system of accounting is an incorrect proposition of law as held by the Apex Court. Even in a mercantile system of accounting cash receipts and cash out goings are to be taken into consideration while computing the taxable income. In the present case there are no outstandings not collected at the end of the accounting period so far as recipient is concerned.

28. Reliance on behalf of the assessee on the decision of the Hon'ble Supreme Court in case of Dr. Shamlal Narula Vs. Commissioner of Income-tax, Punjab, Jammu & Kashmir, Himachal Pradesh & Patiala (supra) instead of assisting the case of the assessee lays down the proposition that interest can be termed to be a compensation for deprivation of the money or the damages awarded for acquisition of land i.e. in a case where "the money was due to him and was not paid or, in other words, was withheld from him by the debtor after the time when payment should have been made, in breach of his legal rights." In the present case, the position is in fact contrary, the payer company has made payment as per terms of the contract. Nothing has been withheld or retained by the payer company and the legal right of the recipient assessee stands extinguished in terms of the contract. Therefore, even on this count, it is not possible to accept the contention raised on behalf of the respondent assessee that the entire interest actually received during the year under consideration should be spread over the period of the debenture i.e. six years.

29. Therefore, reliance by the Tribunal on the decision in the case of Madras Industrial Investment Corporation Limited (supra) is not correct. The Tribunal lost sight of the fact that the said decision in the first instance pertains to the case of the payer company; secondly, it was not a case where the entire liability

had been discharged by the payer company and the right to receive interest satisfied in hands of the recipient.

30. The Tribunal was, therefore, in error in holding that interest income in hands of the assessee who was allotted debentures by the companies was required to be taxed only on proportionate basis. In fact the Commissioner of Income-tax (Appeals) was justified in sustaining the addition of whole amount of interest Rs.62/- per debenture in the accounting year in question. The question is, therefore, answered as aforesaid.

31. Before parting it is necessary to take note of the fact that the individual assessee viz. the recipients have returned the proportionate interest income in subsequent assessment years in consonance with the income returned for the year under consideration and upheld by the Tribunal. However, in light of the fact that this Court has held that the entire interest income is taxable in Assessment Year 1995-96 the same income cannot be proportionately brought to tax in any of the subsequent years. In the circumstances it will be open to each individual assessee to move an appropriate application and seek refund, if any, of the proportionate tax relatable to the interest income in each of the subsequent years in question. Needless to state that, in case any such application is moved revenue shall not deny the legitimate claim by raising any plea of limitation in light of the order made today for Assessment Year 1995-96.

32. Tax Appeal No.157 of 2000 is, therefore, allowed and similarly Tax Appeal No.328 of 2000 is also allowed and both the appeals stand disposed of accordingly.

Registry to place a copy of this order in connected matter.

Sd/- Sd/-

[D.A.MEHTA,J] [H.N.DEVANI,J]

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'Bhavesh'